

STATE OF MAINE  
PUBLIC UTILITIES COMMISSION

Docket No. 2002-21

June 18, 2002

NORTHERN UTILITIES, INC. – MAINE  
Request for Approval of Affiliated Interest  
Transaction with NiSource Corporate  
Services, Inc.

EXAMINERS' REPORT

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**NOTE:**      **This Report contains the recommendation of the Hearing Examiner and is in draft order format. Parties may file responses or exceptions to this Report on or before June 26, 2002. It is expected that the Commission will consider this report at its deliberative session on July 1, 2002.**

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**I.      SUMMARY**

We approve Northern Utilities, Inc.'s (NU, Northern or the Company) proposed management services agreement with NiSource Corporate Services Company (NCSC) subject to the conditions outlined below. Our approval of the contract does not constitute a determination of a reasonable level of costs that may be charged to NU under this contract for inclusion in future rates. We also require Northern to file an updated management service agreement with its immediate parent, Bay State Gas Company, within 90 days.

**II.      OVERVIEW**

A.      Procedural History

On January 11, 2002, NU filed a petition requesting approval of a Management Service Agreement (MSA) with its affiliate NiSource Corporate Services Company (NCSC), pursuant to 35-A M.R.S.A. §707. The Company noted that it had

Commission approval to obtain and pay for certain corporate services from another affiliate, Bay State Gas Company (BSG), but was now seeking to obtain the same and other services directly from NCSC.

On January 18, 2002, the Hearing Examiner issued a Notice of Proceeding inviting intervention or comment from interested persons. The Office of the Public Advocate (OPA) filed the only petition for intervention and this was granted at the initial case and technical conference on February 14, 2002. The Commission's Advisory Staff (Staff) issued a data request on January 25, 2002 and Staff and the OPA explored the filing and followed up on the Company's responses to the initial data request at the February 14 conference.

Between February 14 and March 19, 2002, Staff issued two additional data requests, and on March 19, Staff and the OPA attended a technical conference at NU's Portsmouth, New Hampshire offices. This joint technical conference included staff members from the New Hampshire Public Utilities Commission and the New Hampshire Office of Consumer Advocate (OCA) who were investigating the MSA in the context of an on-going NU rate case there.

Following this session, the Company owed Maine and New Hampshire Staff a substantial number of responses to oral data requests that originated in that session. Due to the number of responses the Company had to prepare, and also because NU attempted to satisfy the New Hampshire requests first, its responses to the MPUC Staff were delayed until such time that it was not possible for the Staff to complete an examiners report and allow for exceptions before the expiration of the statutory case deadline on May 10, 2002. Consequently, the Company voluntarily

withdrew its application on April 29, 2002 and re-filed it the same day to extend the time allowed for review of the proposed contract. On May 22, 2002, Staff filed its fifth and final data request, and the Company responded on May 30, 2002.

B. Background

Since late 1979, Northern had been a subsidiary of BSG and had received management services from its affiliate under an agreement that allocated costs using the “Four-Part or Massachusetts Formula”. At that time, Granite State Gas Transmission, Inc., an interstate pipeline serving both BSG and Northern, was a subsidiary of Northern. These three affiliates comprised the entire BSG corporate family, which shared a broad range of services ranging from financial, data processing, recordkeeping, and engineering to gas supply procurement and rates. The Four-Part Formula allocated all costs to provide services to these affiliates based upon an average of the individual utility’s percentages of utility plant, sales volume, number of customers, and operating payroll to the total. Although in *Request for Approval of Reorganization – Merger with NIPSCO Industries*, Docket No. 98-216, a new corporate structure was established making BSG a subsidiary of NIPSCO (later renamed NiSource, Inc.), Northern continued to track any management services it received from the larger corporate entity through BSG allocating the associated costs under the existing affiliate service agreement using the Four-Part Formula.

Following the merger of NiSource, Inc. and the Columbia Gas System, approved in *Request for Approval of Reorganization – (NiSource – Columbia Merger and Related Transactions)*, Docket No. 2000-322, NiSource formed a corporate services group, NCSC, to consolidate the service needs of its affiliates. As currently

envisioned, the majority of management services will now be provided by NCSC and, as a result, NCSC has an agreement with all its affiliates to provide certain services. The agreement also spells out how NCSC will allocate costs to affiliates.

C. Legal Authority

Section 707(3) Title 35-A prohibits utilities from transacting for services with affiliates unless we have found that the arrangement is not adverse to the public interest and have given it written approval. Subsection 707(3)(B) authorizes the Commission to grant approval subject to such terms and conditions as it determines necessary to safeguard the public interest. Subsection 707(3)(D) states that approval of an arrangement under this section does not limit or restrict the Commission's authority under Title 35-A in determining any rate, charge, or schedule.

Chapter 820 of the Commission's Rules governs the record keeping, accounting, and structural requirements for non-core utility activities and transactions between affiliates. Subsection (4)(E) of the rule specifies that equipment, facilities, services or personnel of an affiliate used by a utility shall be priced at the same price charged non-affiliates, or, if no such price is available, at market price. Subsection 9 of the rule allows us to waive the requirements of Chapter 820 upon a finding of good cause and that the waiver would not be inconsistent with the requirements of sections 707, 708, 713, 714 and 715 of Title 35-A.

D. Record

The record of this proceeding shall consist of all transcripts and documents (including data requests and responses) filed with the Commission.

### III. Proposed Management Agreement

In its application, Northern requests approval of a Service Agreement with NCSC dated January 1, 2001.<sup>1</sup> This agreement outlines both the types of services to be provided and the methodology by which the costs of providing those services will be charged. According to statements made by NCSC representatives, the proposed Service Agreement is the same agreement signed by all the companies, both regulated and non-regulated, in the NiSource, Inc. corporate family. Schedule A, Article II, Description of Services, allows NCSC to provide almost any type of service to its affiliates, including:

- Accounting and Statistical Services
- Auditing Services
- Budget Services
- Business Promotion Services
- Corporate Services (includes dealings with regulatory bodies)
- Data Processing, Tabulating and Calculating Services
- Depreciation Services
- Economic Services
- Electronic Communication Services

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<sup>1</sup>In its initial filing, Northern indicated that due to the continuing realignment of responsibilities among NiSource affiliates, the Company did not seek authorization from this Commission at that time. However, Northern did receive and pay invoices from NCSC under this agreement for a period in 2001. Because Northern's management later recognized that these transactions were not legally valid, NCSC issued a credit in January 2002 for \$466,447 to Northern for amounts billed prior to that date pursuant to the Service Agreement and rebilled Northern for these services through the Bay State Management Agreement. The response to Advisor's 3-5 indicates that Northern would defer any further costs billed by NCSC until a decision is reached in this proceeding.

- Employee Services
- Engineering and Research Services
- Gas Dispatching Services
- Geology and Production Services
- Information Services
- Insurance Services
- Methods Services
- Office Space
- Officers
- Operational and Planning Services
- Purchasing and Storage Services
- Rate Services
- Stationery Services
- Tax Services
- Transportation Services
- Miscellaneous Services

The Service Agreement states that NCSC will furnish such services to Northern "as the Client may from time to time request." MSA at 1. In most instances, the service description states that NCSC will "advise and assist" the Client or Associate in the matters at issue and will perform certain services at the affiliates' request.

Article III of Schedule A of the Management Service Agreement discusses compensation for services rendered. Two types of services, stationery and data

processing services, will be charged on a per unit basis. NCSC will calculate the total cost of providing the service and divide that figure by estimated total units to get the per unit charge. NCSC will true up this calculation on at least an annual basis.

All other costs incurred on behalf of affiliated companies will be charged utilizing direct billing whenever possible. When direct billing is not possible, NCSC will allocate costs utilizing an approved SEC allocation basis.

The administrative and/or indirect costs of NCSC will be accumulated and then charged as an overhead adder on all direct labor charges made to affiliated companies based upon each individual company's percentage of direct labor charges to the total NCSC direct labor charges.

#### **IV. ANALYSIS & DECISION**

##### **A. NCSC Contract**

In determining whether this contract is not adverse to the public interest, we must focus on three aspects of it. First, how much control does Northern have in determining whether it obtains services from NCSC rather than another source? Second, will the costs be allocated fairly among the NiSource family so that Northern will not subsidize the operating costs of other affiliates? Lastly, do the contract and the cost allocations specified therein meet the requirements of Chapter 820? The first two points provide assurance that ratepayers will not bear inappropriate costs. The last ensures that affiliate services are priced fairly, e.g. to avoid cross-subsidies or unfair competitive advantages in the market place.

We believe that NU should be able to determine the services that it needs from NCSC by comparing their nature and cost to the resources available to it from its

own employees and other vendors. We would expect Northern to compare both price and quality of services in making its selections. In response to Advisor's Data Request No. 1-1, NU indicated that it has the right to conduct searches to determine if the services offered by NCSC represent the best overall price option. Company witness Timothy J. Tokish, Jr., NU's Vice-President, Finance, also confirmed this in the February 12, 2002 technical conference. Tr. at 9 – 13. Northern explained that Mr. Tokish determines whether to purchase services from NCSC based upon his evaluation of available options. However, Mr. Tokish noted that comparable options do not exist in the market place for certain services, such as accounting, due to the nature of the corporate structure. Under those circumstances, NCSC will be the only option. We also questioned whether Mr. Tokish can truly exercise independence on such decisions, since both he and Mr. DeVito, NCSC's Controller, are supervised by Robert Skaggs, President and CEO of Bay State Gas Company.<sup>2</sup>

To provide better assurance that best cost options are pursued, we condition approval of this contract on requiring Northern to provide support for the selection of NCSC as a provider for any service when Northern intends to request recovery of the related costs in rates. This includes providing support for the decision not to compare the overall cost of services received from NCSC with other providers as well as documentation of any actual searches made.

We also note here that we are somewhat uncomfortable with the Miscellaneous Services provision included under Article II, paragraph Y of the agreement. The service

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<sup>2</sup> Mr. Skaggs also hold the same title at Columbia Gas of Ohio, Columbia Gas of Kentucky, Columbia Gas of Pennsylvania, Columbia Gas of Maryland, and Columbia Gas of Virginia.



descriptions defined in paragraphs A through X of Article II seem sufficiently broad to encompass most conceivable services that would be necessary for a natural gas LDC. Company witness Bryant acknowledged as much at the February 14 Technical Conference Tr. at 76-77. Our concern is due to the fact that the inclusion of a provision such as the one proposed in paragraph Y might have the effect of making *any cost* fair game for pass through. In our Order in *Request For Approval of Affiliated Interest Transaction For Two Service Agreements With Energy East Management Corporation, Central Maine Power Company et al*, Docket No. 2001-178, we approved a stipulation that limited the services that could be provided “to those services specifically listed in the agreements and to special services that do not materially add to those services listed...” Order at 4. We believe that it is appropriate to be as specific as is reasonably possible, which the stipulation in Docket No. 2001-178 attempted to do. We will therefore adopt a condition that was proposed by Mr. Bryant at the February 14 Technical Conference regarding Miscellaneous Services. That is, that for charges under Miscellaneous Services to be recoverable in rates, they must be only for services that could reasonably be considered to be traditional for a natural gas LDC. Tr. at 78, lines 4-17. We caution the Company that while all costs charged to Northern under the MSA will be subject to careful review in a rate case, this category of management service charges will require particular scrutiny due to its vagueness, no matter the level of costs.

Next, we look to how the costs will be allocated among affiliates. NCSC has adopted the job order system previously used by Columbia Corporate Services group as well as the allocation methods used. We understand that, when possible,

costs are directly assigned through a process where specific job orders are set up within NCSC and all related costs, including direct labor hours, will be charged to that job. We strongly believe that, when possible, all costs should be directly assigned. When the job order is set up, a determination is made as to which affiliates should be charged so that if the work is for a single affiliate only that affiliate will receive the related charges. Conversely, if the work is done for more than one affiliate, than NCSC will charge each affiliate benefited accordingly.

For costs that cannot be directly assigned, NCSC will determine which SEC approved basis should be used to allocate costs after aggregating those costs with similar cost characteristics. In his prefiled testimony, Company witness, Vincent DeVito, Controller of NCSC, stated that there were currently 18 SEC-approved bases for allocating costs and listed those bases. DeVito Test. at 7-8. Upon further review, however, we determined that NCSC does not currently use all of the listed bases nor has it used several of them for an extended period of time. This was confirmed by the report from the Security and Exchange Commission's (SEC) 1999 audit (Finding No. 9) of Columbia Corporate Services (Columbia).<sup>3</sup> The SEC required Columbia to obtain SEC approval for use of the latent bases prior to using them again. The allocators that are used or available for use include:

- Gross Fixed Assets and Total Operating Expenses
- Number of Retail Customers
- Number of Regular Employees
- Fixed Allocation Percentage

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<sup>3</sup> Columbia Corporate Services was the Service Company in the Columbia Gas Company holding company system.

- Number of Transportation Customers
- Total Employees, Customers
- Total Plant, State Employees, Customers
- Total Tariff and Transportation
- Direct Costs (percentage of affiliate direct costs to total direct costs assigned)

We have reviewed the SEC allocation bases and find that the allocators appear to be reasonable. However, what is more important than the bases themselves is whether NCSC selects the most appropriate bases to assign costs among the affiliates. As this cannot be determined in advance of selection, we would caution Northern to take note of all bases used and to ensure that they are appropriate. We will consider the validity of costs allocated to NU in determining what level of costs is recoverable in rates in any future rate case.

In addition, NCSC must file with this Commission any requests to the SEC for new or changed allocation bases affecting NU. Under the SEC procedure, if no response is received in 60 days, the bases are considered approved for use. We, therefore, require NCSC to provide us with timely copies of any such requests made of the SEC and to allow us an opportunity to comment on those requests.

The SEC conducts periodic examinations of holding company service companies under the Public Service Company Holding Company Act. We will only of approve this request under the condition that NCSC notify us of any such audits, allow us the opportunity to participate to the degree we feel necessary, and provide us with copies of all preliminary and final reports, as well as the NCSC's responses to those

reports. We understand that there is currently an audit of NCSC ongoing and would include any preliminary reports issued to date in that audit as well.

In reviewing the information provided in this case, we noted that NCSC indicated that it would charge its cost of operations as an overhead adder to all direct labor charges made to the affiliates it serves. In one response, it indicated that this would be as high as 144% of the direct charge in question. This rate will change monthly based upon the amount of costs incurred and the direct labor charges. We have concerns that the costs of operating NCSC appear extraordinarily high and instruct Northern to be vigilant in approving these costs. While the methodology proposed for the allocation of the costs appears reasonable, we remind NU and its affiliate that the allocated costs themselves must also be reasonable. Certainly an overhead charge of 144% on direct charges appears to be excessive and suggests that the cost for services provided by NSCS may not be competitive with outside sources if such high overhead rates persist.

Chapter 820 of the Commission's rules establishes a preference for market pricing for service billings among members of an affiliated group. *Central Maine Power Company, MaineCom Services, Maine Natural Gas, LLC, Maine Electric Power Company, Chester SVC Partnership, Request for Approval of Affiliated Interest Transaction for Two Service Agreements with Energy East Management Corporation*, Docket No. 2001-178, Order Approving Stipulation (July 10, 2001) at 4, 6. If a tariffed rate or market price is not available, Chapter 820(4)(A) requires that utility services provided to affiliates be priced using fully distributed cost (FDC) methodology as a proxy

for market value. The requirements of Chapter 820 are designed to avoid cross-subsidies and to avoid creating an inter-affiliate competitive advantage.

In Docket No. 2001-178, we approved the provision of services by Energy East Management Corporation (EEMC) to its regulated utility affiliates priced using FDC methodology, waiving Ch. 820(4)(E)'s required use of market price for transactions involving the provision of affiliate services to a utility. We did so finding that Energy East's costing would be subject to SEC scrutiny and would be done according to the SEC requirement that all costs be charged using a FDC mechanism. In *Bangor Hydro-Electric Company, Request for Approval of Reorganization and Affiliated Interest Transactions with Emera Energy Services, Inc.*, Docket No. 2001-841, Order (January 8, 2002) at 14, we similarly noted

Because of the impracticality of determining the value of services when there is no active market in which those services are bought and sold, Chapter 820 allows the use of fully distributed cost methodology, "when the market value cannot be practically determined." The value determined in accordance with such methodology thus acts "as a proxy for the market value." Chapter 820 Order at 21. ... Thus, in adopting Chapter 820, we have already determined, in general, that the use of FDC methodology is an appropriate proxy for determining the market value of a service...

As in Docket No. 2001-178, we find good cause to waive the provisions of Chapter 820(4)(E) to allow NCSC to provide services to Northern at FDC using SEC methodologies, rather than market price, if market price cannot be practically determined. Moreover, we find that such a waiver is not inconsistent with the requirements of sections 707, 708, 713, 714 and 715 of Title 35-A. However, in any rate proceeding, we will require Northern to demonstrate the reasonableness of

including in rates any affiliate cost that is not provided at market price. In a stipulation that was filed in Docket No. 2001-178, the parties agreed to the following:

For ratemaking purposes, each of the applicants will provide appropriate market information (which shall mean market rates for such services or, if the applicants conclude that no market rates are available, the explanation supporting the unavailability of market rates) to demonstrate that the costs billed under these agreements are just and reasonable. Such market information shall only be required if and to the extent that an applicant is seeking (or another party is requesting) a rate change (whether in a general rate proceeding, pursuant to a bottom-end earnings sharing mechanism, or as a result of a mandated cost) that includes costs billed under the agreements approved herein. In such a proceeding seeking a rate change, any other party is free to contest the reasonableness of the costs incurred under the agreements approved herein and the applicant seeking to include such costs in its rate change shall have the burden of proof as to the reasonableness of such costs.

We make this provision a condition to approving this agreement. In any instance where Northern proposes to include in rates a cost for affiliate services provided at other than market price, it must show why market rates were not used in accordance with Chapter 820.

B. Bay State Agreement

Although the majority of costs charged to Northern by its affiliates will be through the Management Services Contract with NCSC, some charges will still be made by BSG for services it provides directly to Northern. Currently, these costs are allocated using the Four-Part Formula. However, as noted above, this agreement has been in place for many years and does not appear to properly suit Northern's current situation because it is premised on entirely different corporate relationships. In particular, the

formula includes and allocates to Northern costs attributable to Granite State, which has been moved to NiSource's pipeline division and is no longer a direct affiliate of Northern or Bay State. The Company has acknowledged the need to revise the current BSG MSA and has indicated that it is in the process of revising the agreement and filing it with the Commission for approval. Northern indicated that it expects to use similar allocation principles to those used by NCSC in the revised agreement and expects to eliminate Granite from the agreement and to develop separate agreements between BSG or Northern and Granite as needed.

To ensure timely completion of this project, we direct Northern to file within 90 days a revised management services agreement with its direct corporate parent, BSG, for our review pursuant to Section 707(3).<sup>4</sup> The revised agreement should incorporate the principles of direct charges and where not possible the use of allocators reflecting the cost causers for other costs.

## **V. CONCLUSION**

For the reasons noted above, we find Northern's Management Service Agreement with NCSC not adverse to the public interest and approve it subject to the conditions discussed in the body of this Order.

Accordingly, we

**O R D E R**

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<sup>4</sup> The Company provided a preliminary draft and undertook a review of services that will be provided by BSG to Northern or Granite or by Northern to BSG or Granite.

1. That Northern Utilities, Inc's petition for approval of its Management Service Agreement proposed in this docket is approved subject to the conditions contained in this Order; and
2. That Northern Utilities, Inc. file, within 90 days of the date of this Order, a revised Management Service Agreement with Bay State Gas Company as discussed in the body of this order.

Respectfully submitted,

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Carol A. MacLennan, Hearing Examiner

With  
Richard Kivela  
And  
Lucretia Smith,  
Finance Division Utility Analysts